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TAGS: EFIN ECON PGOV VE
SUBJECT: BCV'S ABILITY TO DEFEND BOLIVAR WEAKENED

REF: A. CARACAS 00704

¶B. CARACAS 00512
¶C. CARACAS 00943
¶D. CARACAS 00485
¶E. CARACAS 00183

Classified By: Acting Economic Counselor Shawn E. Flatt for Reason 1.4(
D).

SUMMARY

¶1. (SBU) After delaying the issuance of its financial statements for a month, the Central Bank of Venezuela (BCV) finally published its March 2006 financial statement showing cumulative 2006 first quarter losses of USD 136 million. These losses are mainly due to the increasing cost of BCV's efforts to contain monetary liquidity by issuing certificates of deposits (reftel A and B). BCV transfers of international reserves, totaling USD 10.2 billion to the National Development Fund (FONDEN), represent additional BCV losses (reftel C). The BCV has yet to adjust its financial statements to fully show decreases in equity due to the transfers. In May 2006, the Constitutional Chamber of the Venezuelan Supreme Court agreed to hear oral arguments in a lawsuit presented by former BCV officials challenging the constitutionality of the transfers of international reserves and BRV off-budget spending. With BCV losses revealed, BCV directors face pressure from all sides and criticism that the BCV's monetary policy and management of reserves are undermining Venezuela's currency.

CENTRAL BANK LOSSES

¶2. (U) Managing the monetary policy has become increasingly expensive. Money supply increased 53.2 percent from March 2005 to March 2006, largely as a result of high oil prices, increased government expenditures, and exchange controls. To withdraw excess liquidity and mitigate inflationary pressures in the economy, the Central Bank (BCV) has issued certificates of deposits (reftel A). As of March 30, 2006,

the net balance in circulation of certificates of deposits was USD 15.5 billion, which represents a 372 percent increase as compared to the end of 2004. As the certificates of deposits expire, the BCV repurchases them at their original price plus interest, creating a "snow ball" effect in terms of increasing costs. The interest payments for BCV-issued certificates of deposits cost the BCV approximately USD 871 million in 2005, the BCV's largest expenditure.

¶3. (U) The BCV's main income sources are interest received on international reserves allocated abroad and foreign exchange earnings. The BCV earned USD 385 million in interest on international reserves last year. Since the BCV has maintained the current exchange rates of 2,150 Bolivars/USD (sell rate) and 2,144 Bolivar/USD (buy rate) since February 2005, BCV's foreign exchange earnings have continued to decline. (Note: The BCV follows FIFO (first in first out) accounting practices in foreign exchange transactions. This means that U.S. dollars bought when the dollar was at the 1,600 Bolivars/USD and 1,920 Bolivars/USD, were sold at 2,150 Bolivars/USD. The BCV is currently selling U.S. dollars that were bought at 2,144 Bolivars/USD (buy rate). End Note.) Foreign exchange earnings during 2005 were USD 2.1 billion, but with no devaluation this year to date, these earnings have declined significantly. With higher expenses and lower income, the BCV March 2006 financial balance sheet showed financial operational losses (flow of income and expenses) of USD 136 million.

¶4. (C/NF) The USD 6 billion transfer of international reserves to the National Development Fund (FONDEN), authorized by the July 2005 Central Bank Law, and recent transfers totaling USD 4.2 billion demanded by Chavez represent additional losses to the BCV (reftel C). Orlando Ochoa, economist with local brokerage house InterAcciones, noted that governments usually withdraw from the international reserves in times of crisis, but Chavez is withdrawing funds during an oil boom.

¶5. (C/NF) The BCV initially used unorthodox accounting methods to hide the decrease in equity (stock of funds) from FONDEN transfers. The BCV reduced foreign currency assets by the amount of the FONDEN transfers, but added a new asset in Bolivars for the same amount. By accounting this way, the BCV never showed a reduction in assets, or consequently a reduction in equity (stock of funds). (Note: Equity equals assets minus liabilities. End Note.) For March 2006, the BCV continued to show the FONDEN transfers as an asset in Bolivars. However, the BCV also deducted a portion of the BCV transfers (USD 1.9 billion transferred in March 2006) from its equity, partially recognizing the losses. Former BCV Manager of Economic Research, Jose Guerra said that, using correct accounting standards, "the BCV has no equity; in fact, its equity is negative."

FORMER BCV OFFICIALS MAKE THEIR CASE

¶6. (U) The Constitutional Chamber of the Venezuelan Supreme Court agreed to hear oral arguments in a lawsuit by former BCV officials, including Jesus Rojas and Jose Guerra, to declare unconstitutional provisions of the July 2005 Central Bank Reform Law, which authorized the one-time transfer of USD 6 billion in international reserves to FONDEN. (Note: BRV officials have interpreted the law to allow additional transfers beyond a BCV-determined adequate level of reserves. End Note.) The Chamber ordered appearances by the BCV President, the National Assembly President, Attorney General, and the Solicitor General. The Chamber also called petitioners: former BCV Manager of Accounting Jesus Rojas; former BCV Manager of Economic Research Jose Guerra; economist Orlando Ochoa; and Banco de Venezuela de Credito President Oscar Garcia. The petitioners argue that the law violates Articles 318 and 320 of the Constitution, which require the BCV to defend the currency; and Article 314, which prohibits the BRV from spending funds not outlined in the national budget. The petitioners asked that FONDEN pay

the BCV the equivalent of the total transfers in Bolivars and that the BRV register FONDEN expenditures in the national budget. The Constitutional Chamber denied the petitioner's request for a temporary injunction against additional BCV transfers to FONDEN until the case was decided.

¶7. (C/NF) According to Ochoa, the BCV legal council told him privately that the lawsuit was strong and well-presented. However, Ochoa described the members of the Constitutional Chamber as concerned about their professional reputations, but also loyal to Chavez. Guerra speculates that the Chamber will not obligate the BRV to return FONDEN funds to the BCV, but may prohibit additional transfers.

BOARD OF DIRECTORS UNDER PRESSURE

¶8. (C/NF) Contacts said the BCV directors understand that they could be personally liable for the BCV losses, but also face significant pressure to support BRV policies. Citing BCV sources, Ochoa alleged that Chavez pressures the BCV Board through the Minister of Planning Giordani, who attends the BCV Board meetings as the BRV representative, but does not vote. According to Ochoa, BCV Directors said they would resign if the Central Bank Reform Law was passed, but none of them did. Ochoa described BCV director Maza Zavala as "one that gives something to each side) he notes the economy is strong (for the chavistas) and says not sustainable (for the opposition)." Citing inside BCV sources, Ochoa said that BCV President Gaston Parra, widely described as supportive of the BRV policies, was struggling with a morale dilemma. Ochoa described BCV Director Armando Leon as "not trusted by Giordani." Contacts also report resistance to BRV policies from some BCV technical staff.

THE CONSEQUENCES

¶9. (C/NF) Financial sector contacts said that the BCV management is actually undermining Venezuela's currency, but the full impact of BCV's losses is hidden by high oil boom revenue. Guerra said that, with increasing debt, low capital, and lower international reserves (after the transfers), the BCV has less ability to defend the currency. Guerra believes that the BCV will eventually clean up its accounting with a devaluation, most likely in 2007. In addition, Ochoa argued that, because of the BCV's financial problems, the BCV has incentives to make policies that would actually hurt the population. For example, the BCV has incentives to bring down interest rates to reduce the costs of the monetary policy, when it should actually raise interest rates to encourage people to save. Ochoa said that the BCV has already lobbied the BRV for a 5 percent devaluation and criticized the BCV for "reducing the purchasing power and standard of living of an impoverished population." (Comment: Based on discussions with local contacts, the conventional wisdom is that the BCV will devaluate in 2007. Estimates for the devaluation vary, up to 15 percent. End Comment.)

COMMENT

¶10. (SBU) The BRV's aggressive election year spending will continue to increase the money supply and challenge the BCV. The BRV is intensely focused on short-term priorities, e.g. spending to gain political support, pressuring the BCV to maintain low interest rates, and maintaining the fixed exchange rate at the current level. However, like many of our contacts, we believe that the accumulation of distortions in the economy is not manageable in the medium or long-term.

BROWNFIELD